

Message Text

CONFIDENTIAL

PAGE 01 SANTIA 01939 012250Z

73

ACTION ARA-10

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03

INR-07 NSAE-00 TRSE-00 XMB-02 OPIC-03 SP-02 CIEP-01

LAB-04 SIL-01 OMB-01 DODE-00 PA-01 USIA-06 PRS-01

PM-03 NSC-05 SS-15 /078 W
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R 012202Z APR 75

FM AMEMBASSY SANTIAGO

TO SECSTATE WASHDC 2708

C O N F I D E N T I A L SANTIAGO 1939

EO 11652: GDS

TAGS: ECON, EFIN, CI

SUBJ: GOC APPROACHES MOMENT OF TRUTH IN ITS BATTLE AGAINST
INFLATION

REF: SANTIAGO 1729

1. SUMMARY. GOC ECONOMIC LEADERS ARE CONVINCED THAT BUDGET DEFICIT MUST BE CUT SHARPLY FROM PRESENTLY EXPECTED LEVEL (OVER 20 PERCENT OF EXPENDITURES) IF ANY SIGNIFICANT PROGRESS IS TO BE MADE IN SLOWING CHILE'S GALLOPING INFLATION DURING 1975. ECONOMISTS HERE BELIEVE THAT MILITARY LEADERSHIP MUST ACCEPT DRASTIC BUDGET CUTS AND SOME ADDITIONAL UNEMPLOYMENT OR ENTIRE ECONOMIC PROGRAM MAY BE IN DANGER. END SUMMARY.

2. GOC ANNOUNCED RECENTLY THAT CENTRAL GOVERNMENT BUDGET DEFICIT (INCLUDING SUBSIDIES TO GOVERNMENT BUSINESS ENTERPRISES) IS NOW RUNNING AT ANNUAL RATE OF MORE THAN 20 PERCENT OF EXPENDITURES, COMPARED TO 15-18 PERCENT ORIGINALLY PLANNED.

3. DURING MARCH 26 DINNER AT EMBASSY RESIDENCE HONORING MILTON FRIEDMAN, ECOM COUNSELOR HAD LONG DISCUSSIONS WITH MINISTER OF FINANCE CAUAS AND MINISTER OF ECONOMY LENIZ ABOUT CHILE'S HIGH RATE OF INFLATION. BOTH SAID THAT STEPS
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PAGE 02 SANTIA 01939 012250Z

MUST BE TAKEN IMMEDIATELY TO CUT CENTRAL GOVERNMENT BUDGET

DEFICIT OR NO SIGNIFICANT PROGRESS CAN BE EXPECTED THIS YEAR
ON GETTING PRICE RISES UNDER CONTROL. CIVILIAN ECONOMIC
TEAM IS NOW TRYING TO SELL THIS CONCEPT TO MILITARY JUNTA.

4. CAUAS BELIEVES THAT BUDGET CUTS CAN BE MADE MOSTLY IN
INVESTMENT PROJECTS OF GOVERNMENT ENTERPRISES. HE IS SEARCHING
FOR WAYS TO DO THIS WITHOUT GREATLY INCREASING UNEMPLOYMENT.
LENIZ SAID THAT CUTBACKS MUST INVOLVE SUBSTANTIAL FURTHER
REDUCTION IN PUBLIC SECTOR EMPLOYMENT. HE RECOMMENDS PUTTING
THOSE LOSING JOBS TO WORK ON LEAF-RAKING PROJECTS AS RELATIVELY
CHEAP MEANS OF GIVING THEM MINIMUM INCOME NEEDED TO CONTINUE
EATING. BOTH SEEM TO FEEL THAT FAILURE TO TAKE NECESSARY ANTI-
INFLATIONARY STEPS NOW WOULD ENDANGER THE ENTIRE ECONOMIC
PROGRAM BECAUSE PRESENT GENERAL DISILLUSIONMENT WITH EFFECTIVE-
NESS OF PROGRAM WILL DEEPEN IF INFLATION NOT DAMPED SOON.

5. COMMENT: GETTING MILITARY ACCEPTANCE OF REALLY DRASTIC
BUDGET CUTS WILL NOT BE EASY. JUNTA IS GENUINELY CONCERNED
ABOUT CHILE'S POOR AS WELL AS ABOUT GOC POPULARITY. SEVERE
AUSTERITY AFFECTS BOTH IN SHORT RUN. RECENTLY ANNOUNCED
CHANGES IN MANAGEMENT OF NUMEROUS GOVERNMENT ENTERPRISES
(SEE REFTTEL) WERE AIMED AT GETTING BETTER GOVERNMENT CONTROL
OVER EXPENDITURES OF THESE ORGANIZATIONS. IT WILL TAKE
MUCH MORE THAN THIS, HOWEVER, TO REDUCE FISCAL DEFICIT TO
MORE MANAGEABLE LEVELS.

6. INCREASING NUMBERS OF CHILEANS AND FOREIGN ECONOMISTS
ARE NOW CONVINCED THAT GRADUALIST APPROACH TO REDUCTION OF
INFLATION TRIED HERE FOR LAST 18 MONTHS HAS FAILED--NOT
BECAUSE CONCEPT WAS WRONG BUT BECAUSE IMPLEMENTATION WAS
POOR. INTERNAL GOC DISCIPLINE WAS NOT STRONG ENOUGH FOR
GRADUALISM. GOVERNMENT DEFICITS AND MONEY SUPPLY HAVE
CONSISTENTLY EXCEEDED PROGRAMMED LEVELS. WHEN MAGNITUDE
OF JANUARY-MARCH 1975 DEFICIT FINANCING BECAME KNOWN LAST
WEEK, GOC ECONOMIC TEAM BEGAN CALLING FOR DEFLATIONARY "SHOCK."
ONLY IN THIS WAY, THEY REASON, CAN INFLATIONARY SPIRAL BE
BROKEN AND INDIVIDUAL EXPECTATIONS CHANGED. WHILE THIS POLICY
WILL MEAN GREATER SHORT-TERM PAIN IN THE FORM OF LOWER GDP
AND HIGHER UNEMPLOYMENT, GOC ECONOMIC TEAM IS NOW TRYING TO
CONVINCE MILITARY THAT THIS IS ONLY ACTION WHICH WILL SUCCEED.
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PAGE 03 SANTIAGO 01939 012250Z

UNDER THESE CONDITIONS IT IS NOT SURPRISING THAT AIR OF GENERAL
FRUSTRATION ABOUT THE ECONOMY HAS BEEN DISCERNIBLE HERE LATELY
AND THAT LEVEL OF BACK-BITING (BETWEEN ECONOMISTS AND SOME
MILITARY AND AT SAME TIME BETWEEN ECONOMIST AND PDC
POLITICIANS) HAS ALSO RISEN.
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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC CONDITIONS, INFLATION, GOVERNMENT BUDGET, ANTIINFLATIONARY PROGRAMS
Control Number: n/a
Copy: SINGLE
Draft Date: 01 APR 1975
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: GolinoFR
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1975SANTIA01939
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Film Number: D750113-0304
From: SANTIAGO
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1975/newtext/t19750493/aaaadgvm.tel
Line Count: 113
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION ARA
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 3
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: 75 SANTIAGO 1729
Review Action: RELEASED, APPROVED
Review Authority: GolinoFR
Review Comment: n/a
Review Content Flags:
Review Date: 08 SEP 2003
Review Event:
Review Exemptions: n/a
Review History: RELEASED <08 SEP 2003 by BoyleJA>; APPROVED <14 NOV 2003 by GolinoFR>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
05 JUL 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: GOC APPROACHES MOMENT OF TRUTH IN ITS BATTLE AGAINST INFLATION
TAGS: ECON, EFIN, CI
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 05 JUL 2006